Department of Labor fiduciary rule

Key considerations for broker-dealers and wealth management companies

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Laurence is a principal in the Financial Services Regulatory practice in KPMG's New York office. He has over 20 years of experience in the financial services industry focusing on legal, risk, and compliance issues in the asset management space. He has held such positions as chief legal officer for asset management, senior counsel, and general counsel at large institutional asset management and dually registered broker-dealer/investment advisory firms. He has worked closely with compliance departments in the creation and implementation of asset management compliance programs. Most recently, he was the head of governance for a large global wealth management firm where he worked closely with the firm's legal, compliance, and risk partners to help ensure the proper development and maintenance of its asset management products and services.

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Introduction

On April 8, 2016, the U.S Department of Labor (DOL) released its final rule expanding the definition of "investment advice" as that term applies to retirement plans, individual retirement accounts (IRAs), pensions, and other types of retirement accounts defined by the Internal Revenue Code of 1986, as amended (the Code), and the Employee Retirement Income Security Act of 1974 (ERISA). Under the new rule package, a person (or financial institution) will be considered a "fiduciary" when they provide "investment advice" to ERISA or IRA plans. Once fiduciary status is triggered, the prohibited transaction provisions of ERISA and the Code will apply, thereby limiting the types of compensation and fees that can generally be charged and received. However, the final rule introduces two new and noteworthy prohibited transaction class exemptions, which firms can elect to comply with in order to receive compensation that would otherwise be impermissible: the Best Interest Contract Exemption (BICE) and the Principal Transaction Exemption.

The new rule, including the new and amended class exemptions, are effective beginning June 7, 2016, but are not applicable until April 10, 2017 (the Applicability Date). The BICE and Principal Transaction Exemption have an additional period of transitional compliance between April 10, 2017 and January 1, 2018, during which time fewer conditions apply to give financial institutions and advisers time to prepare for compliance while safeguarding the interests of investors.[1] Full compliance with all provisions of the rule, including the class exemptions, will be required as of January 1, 2018.

Because the scope of communications and activities that fall into the definition of "investment advice" are extensive, they have forced financial institutions and their advisers to take a fresh look at current business practices, product offerings, and other strategic impacts as they develop an implementation plan.

1 During the transition period, firms and advisers must adhere to the impartial conduct standards; provide a notice to retirement investors acknowledging fiduciary status and describing their material conflicts of interest; designate a person responsible for addressing material conflicts of interest and monitoring advisers' adherence to the impartial conduct standards; and follow record-keeping provisions.

Key considerations for broker-dealer and wealth management companies

The following are several key considerations for firms to be mindful of as they digest the final rule package and its relevant impacts.

Impacts on broker-dealers and investment advisers

1. **Migration to a "level fee" platform.** The financial services industry is likely to see an increase in "Level Fee" arrangements offered to its clients. A Level Fee is defined in the exemption as a fee or compensation that is provided on the basis of a fixed percentage of the value of the assets, or a set fee, that does not vary with the particular investment recommended, rather than a commission or other transaction-based fee. Under the new rule, "Level Fee Fiduciaries" that give ongoing advice on a relatively unconflicted basis will be able to rely on "streamlined" compliance requirements of the BICE. Level Fee Fiduciaries do not have to have a written contract, adopt written policies and procedures to ensure compliance with BICE, maintain a Web site with the information described above, or provide transaction-based disclosures. However, they must:
   a) confirm their fiduciary status in writing,
   b) comply with the "impartial conduct standards," and
   c) (in the case of a rollover from an ERISA-covered plan to an IRA) provide written documentation of the reasons for their recommendations.

   These steps must be taken prior to or at the same time as the execution of the recommended transaction. In addition, the documentation must include an analysis of the investor's alternatives to a rollover, including leaving the money in his or her current employer's plan or placing the money in a new employer's plan in the case of a job change. It must also take into account, among other things, the fees and expenses associated with the plan(s) and the IRA.

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> “The strong need for documentation to support recommendations made in accordance with a best interest standard is a common theme for the industry as firms work their way through the new rule and toward a proper compliance regime,” said **Laurence Godin, principal and national practice leader** for Investment Management at KPMG. “Although detailed contemporaneous documentation supporting the rationale for recommendations made to retirement clients is a cultural and procedural change for most advisers today, we see it as a necessary practice to prove that the investment advice was in the best interests of clients at the time it was given.”

Open questions remain with respect to level fee options, including:

- Must the Level Fee compensation come solely from the client or can it come from other sources as long as its “level”?
- Can firms gather enough information about plans clients may be rolling out of in order to do the proper analysis required by the rule?

2. **Migration toward fee-based investment advisory relationships.** The industry is likely to see a migration away from the traditional brokerage model towards advisory ones. Aside from operational and timing challenges, firms switching their clients from commission accounts into fee-based retirement ones will need to address existing FINRA and SEC rules while ensuring that such recommendations are in the best interests of clients under the new DOL fiduciary standards.

3. **Legacy assets.** The DOL expanded the “grandfather” relief for compensation associated with investments made prior to the BICE’s applicability date to ease the transition for institutions and advisers that could become fiduciaries. The final rule package extends grandfather relief to cover all investment products (not just assets) and permits additional advice on pre-existing investments to be provided after the applicability date, provided that compensation received is “reasonable” and the recommendation reflects the “care, skill, prudence, and diligence under the circumstances” required throughout the rule. In addition, the final exemption also provides a transition period, discussed *supra,* under which prohibited transaction relief is available for financial institutions and advisers during the period between the applicability date and January 1, 2018, subject to more limited conditions.

   Firms deciding to comply with the BICE requirements may elect to make permanent use of the legacy provisions. If so, firms will need to identify legacy assets and accounts and install stringent compliance measures to ensure that “grandfather” accounts do not violate DOL requirements by receiving new advice. However, firms must balance this approach against the reality that supervising a lack of advice may not be a practical solution and the risk associated with triggering the rule.

4. **Financial adviser compensation.** In order to meet the fiduciary standard, firms will need to review current financial adviser compensation arrangements to understand the differences in what financial advisers charge to clients in an effort to ensure that compensation rates and commission schedules are defensible under a best interest standard.

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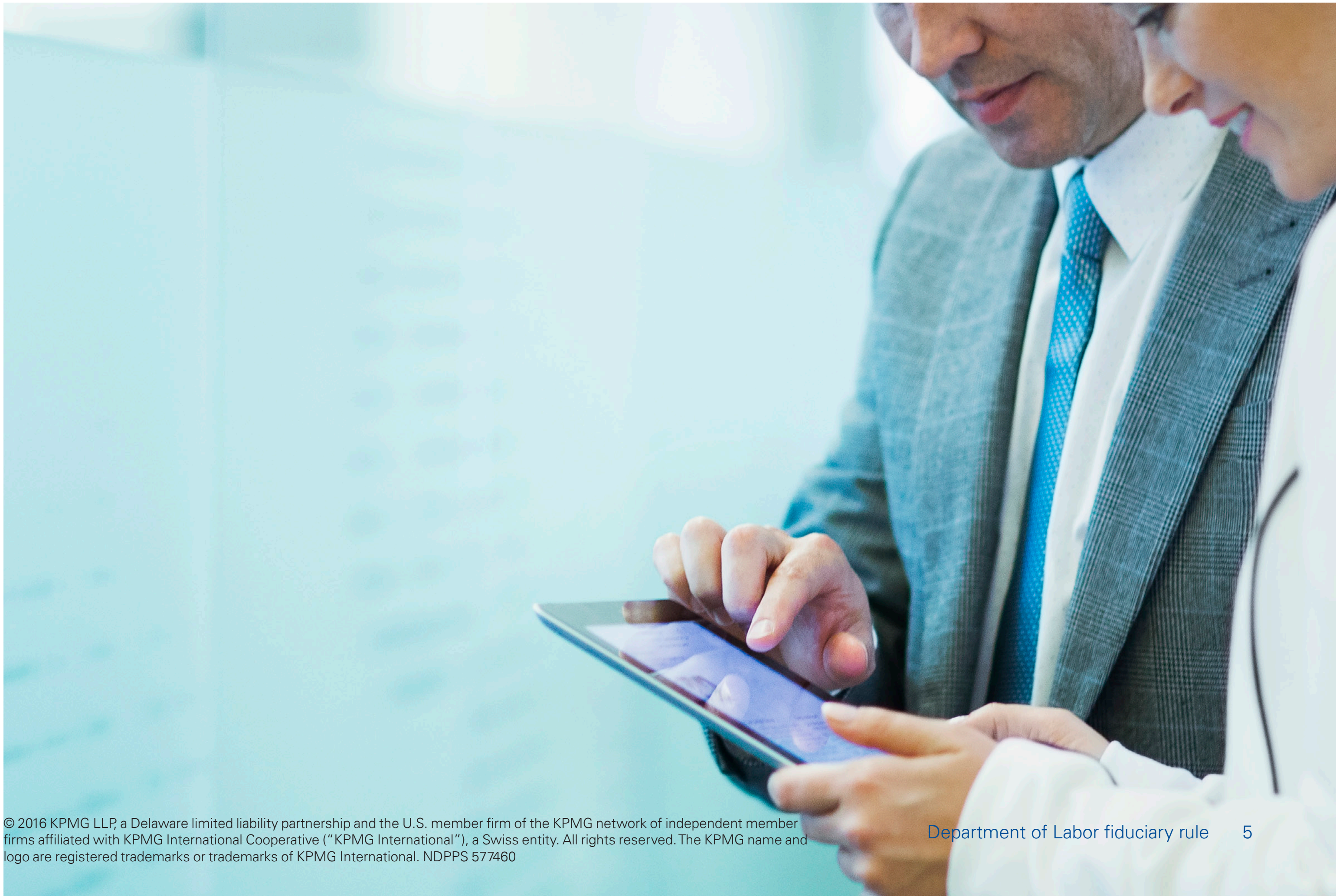
Impacts on institutional investment managers

1. **Migration toward no-load/low-cost options.** In response to the new fiduciary rules, wealth managers may request that mutual fund producers develop share classes without sales loads, 12b-1 fees, or other servicing fees in order to make them friendlier to DOL rulemaking and the new retirement landscape. In general, platform distributors are likely to demand lower fees and expenses in mutual funds and separately managed account platforms to ensure that the platform provider's recommendations remain in the best interest of the customer.

2. **Decline of load fund sales.** In late April, a large broker-dealer confirmed it would be removing mutual funds with sales loads from its platforms. We expect this trend to continue towards a general decline in load fund sales, reflecting a trend toward lower cost for customers while mitigating conflicts of interest in providing investment advice.

> "The advent of the new rule will have a transformational impact on the type of products that will be developed for retirement clients," said **Howard Margolin, DOL Fiduciary Rule lead partner**. "Although we are only a couple of months into the issuance of the final rule, we have seen its effect on traditional products such as mutual funds and ETFs. The industry should expect greater use of retirement-friendly mutual fund share classes, fee compression, and a continued movement toward passive management."



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Conclusion

The DOL's new rule package is substantial and will take time for firms and service providers to fully digest; however, this does not mean that firms cannot begin mobilizing toward compliance while the impacts are fully assessed. Identifying the universe of impacted products and accounts can take time. Even after firms decide upon their implementation strategy, significant efforts are expected to be required in identifying/developing compliance controls, understanding and inventorying conflicts of interest, drafting policies and procedures, reviewing and monitoring marketing materials, and providing training to impacted employees.

Currently, a great deal of ambiguity surrounds the implementation of the rule, which may lead to unintended consequences for the industry. The full effect of the rule on firms and their customers will continue to evolve as it comes into clearer focus.

How KPMG can help

KPMG has extensive experience in regulatory change management and has developed a DOL approach to assist institutions during this period of dynamic change. We would welcome the opportunity to discuss the DOL final rule, and your specific implementation needs, in greater detail.

Contact us

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